VZCZCXRO0609
OO RUEHAG RUEHAST RUEHDA RUEHDBU RUEHDF RUEHFL RUEHIK RUEHKW RUEHLA
RUEHLN RUEHLZ RUEHNP RUEHPOD RUEHROV RUEHSK RUEHSR RUEHVK RUEHYG
DE RUEHVB #0168/01 0851305
ZNR UUUUU ZZH
O 261305Z MAR 09
FM AMEMBASSY ZAGREB
TO RUEHC/SECSTATE WASHDC IMMEDIATE 9104
INFO RUEHZL/EUROPEAN POLITICAL COLLECTIVE PRIORITY
RUEATRS/DEPT OF TREASURY WASHDC PRIORITY

UNCLAS SECTION 01 OF 02 ZAGREB 000168

SENSITIVE
SIPDIS

DEPARTMENT FOR EUR/SCE, EUR/ERA, EEB/IFD, TREASURY FOR
INTERNATIONAL AFFAIRS ERIC MEYER AND LARRY NORTON

E.O. 12958: N/A
TAGS: ECON EFIN HR
SUBJECT: CROATIAN TOURIST SEASON WILL BE KEY FACTOR IN
FINANCIAL STABILITY

¶1. Summary. The Croatian National Bank (HNB) over the past several years has very successfully maintained the exchange rate due to strong foreign currency inflows from the tourism sector, foreign direct investment, and a significant foreign reserve position. All these sources of kuna stability have now been cast into doubt by the global financial crisis. As the government's budget negotiations with the state sector unions are reaching a crisis point (to be reported septel), economists and government officials are looking forward with concern to the tourist season. Should foreign currency revenue from tourism severely drop this summer, or a bond issue planned for late April fail, both the state budget and the exchange rate will be under extreme pressure. Officials in and outside the government are increasingly willing to openly admit that such a scenario would require intervention by the IMF. End summary.

¶2. Like many countries of central and eastern Europe, Croatia's economic boom of the last decade was financed largely by the expansion of credit to consumers and private sector enterprise. Of this lending, approximately 70 percent of household and corporate loans are either denominated directly in foreign currency, or indexed to a foreign currency, mostly the euro. For this reason, the central bank has kept strict control over the exchange rate, fearing severe economic (and political) consequences of a strong slide in the kuna.

¶3. The central bank forecasts a current account deficit of 3 billion euro for 2009. According to the central bank's director of financial stability, any shortfall in tourism revenue or foreign direct investment will be made up for this year by expenditure of foreign exchange reserves (currently estimated at about 8 billion euro). The government also intends to issue a bond in April or May for around 1 billion euro. This forecast makes large assumptions: first, that tourism revenue will drop by only 3 - 5 percent this year; second, that at least some foreign investment can be attracted this year; and third, that the government's bond issue will be successful. (Comment: all these assumptions seem highly optimistic and risky. Although impossible to judge yet, we have seen tourism forecasts predict as much as a 20 percent drop in revenue. Also, the government's very public fight with unions over stabilizing state finances will not go unnoticed by the bond markets. End comment.)

¶4. The central bank also shared with us a study they recently completed testing the stability of the banking sector. In general, their models show a fairly resilient banking sector. Their conclusion was that a 10 percent depreciation in the kuna, coupled with a 1-2 percent decline in real GDP growth, would likely result in only one of the smaller banks in Croatia facing a severe lack of capital. Although the financial stability director used this study to

show that the risk to the Croatian banking sector was "quite low," we pointed out that GDP growth forecasts are already close to the economic "stress" scenarios used in both theirs and the IMF's stress testing models.

¶5. As the economy grinds forward, more public officials and independent observers have been willing to admit that an IMF bailout may become inevitable. The director of the World Bank office in Zagreb unequivocally told the DCM the IMF would have to intervene to stabilize state finances and the exchange rate. The President of the Croatian Bank for Reconstruction and Development was less sure, but said an approach to the IMF would be taken much more seriously after the May local elections. Even the Finance Minister, always a vocal champion of the "we can manage alone" public line, has begun to say in the media that the IMF is "not the bogeyman" and that IMF intervention would not be disastrous for Croatia.

¶6. Comment: The Croatian economy has muddled through until now, but political and economic realities are beginning to converge. With public sector unions threatening strikes, local elections in May, and the all-important tourist season beginning immediately after, Croatia is entering a critical phase. These realities were obviously not lost on Standard and Poors, which recently downgraded Croatian kuna-denominated debt to BBB, which is a reflection of the increasing likelihood of kuna depreciation and the government's growing difficulty to borrow. But Croatia can still find a way out - if the unions accept a temporary wage freeze, the government puts off additional expenditures (perhaps to expensive infrastructure projects like the Peljasac bridge), and the drop in tourism is mild, then the economy can still avoid a painful IMF to-do list. If,



however, the economy contracts by more than 5 percent or the tourist season by more than 10 percent, Croatia will be in uncharted, and unmodelled, waters.
BRADTKE